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In the

Supreme Court of the United States

October Term, 1977

No. 77-332

F. Eberstadt & Co., Inc., F. Eberstadt & Co., Managers and Distributors, Inc., and Robert G. Zeller,

Petitioners,

—against—

Susan Tannenbaum and Chemical Fund, Inc.,

Respondents.

MOTION OF INVESTMENT COMPANY INSTITUTE FOR LEAVE TO FILE A BRIEF AS *AMICUS CURIAE* AND BRIEF IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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TABLE OF CONTENTS

PAGE

Motion 1a

BRIEF:

SUMMARY 2

ARGUMENT 3

I. Under applicable law and industry practice disclosure of the possibility of recapture and the decision of the independent directors to forego recapture is not, and should not be, required 3

A. The SEC has not required disclosure of the possibility of recapture and the decision not to recapture and such disclosure has not been common practice in the mutual fund industry 3

B. The interests of the shareholders of mutual funds are protected by the independent directors 7

C. The omission of a disclosure in proxy materials as to the possibility of recapture and the decision of the independent directors to forego recapture is not material 9

II. The Court of Appeals' decision will have a disruptive impact on the mutual fund industry 11

CONCLUSION 14

Table of Authorities

Cases: PAGE

Brown v. *Bullock*, 294 F.2d 415 (2d Cir. 1961) 11n

Fogel v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975), cert. denied, 429 U.S. 824, 97 S.Ct. 77, 50 L.Ed.2d 86 (1976) 12n

Moses v. *Burgin*, 445 F.2d 369 (1st Cir. 1971), cert. denied sub. nom. *Johnson* v. *Moses*, 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed.2d 547 (1971) 12n

Saxe v. *Brady*, 184 A.2d 602 (Del. Ct. of Chancery 1962) 11n

SEC v. *Insurance Securities, Inc.*, 254 F.2d 642 (9th Cir. 1958), cert. denied, 358 U.S. 823, 79 S.Ct. 38, 3 L.Ed.2d 64 (1958) 12n

Rosenfeld v. *Black*, 445 F.2d 1337 (2d Cir. 1971) 12n

TSC Industries, Inc. v. *Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L. Ed.2d 757 (1976) 9

Statutes:

Securities Act of 1933, 15 U.S.C. §§ 77a et seq. 4n, 5n

Section 6(e) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78f(e) 12, 12n

Section 11(a) of the 1934 Act, 15 U.S.C. § 78k(a)....12, 12n

Section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a)..... 9n

Investment Company Act of 1940 (the "1940 Act"), 15 U.S.C. §§ 80a-1 et seq. 2a, 3, 4n, 7, 10n

Section 2(a)(3) of the 1940 Act, 15 U.S.C. § 80a-2(a)(3) 8n

PAGE

Section 2(a)(19) of the 1940 Act, 15 U.S.C. § 80a-2(a)(19) 8n

Section 10(a) of the 1940 Act, 15 U.S.C. § 80a-10(a) ..7n, 8n

Section 10(b) of the 1940 Act, 15 U.S.C. § 80a-10(b) 8n

Section 10(c) of the 1940 Act, 15 U.S.C. § 80a-10(c) 8n

Section 15(c) of the 1940 Act, 15 U.S.C. § 80a-15(c) 7n

Section 15(f) of the 1940 Act, 15 U.S.C. § 80a-15(f) 12

Section 20(a) of the 1940 Act, 15 U.S.C. § 80a-20(a) 9n

Section 32(a) of the 1940 Act, 15 U.S.C. § 80a-32(a) 7n

Section 36(b) of the 1940 Act, 15 U.S.C. § 80a-36(b) 12

Investment Company Amendment Acts of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970) 7, 8, 8n, 12

Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975) 12

SEC Rules:

Rule 19b-3 under the 1934 Act, 17 Code Fed. Reg. § 240.19b-3 ..... 12n

Rule 20a under the 1940 Act, 17 Code Fed. Reg. § 270.20a 10, 10n

SEC Releases:

Release No. 40-5634 (1969) 5n

Release No. 40-7220 (1972) 4n, 5n

Release No. 34-13388 (1977) 12n

Other Authorities:

S.Rep. No. 91-184, 91st Cong., 2nd Sess. (1970) 7n

3 U.S. Cong. & Adm. News, 91st Cong., 2d Sess. at 4901 (1970) 7n

IN THE

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No. 77-332

F. EBERSTADT & CO., INC., F. EBERSTADT & CO., MANAGERS AND DISTRIBUTORS, INC., and ROBERT G. ZELLER,

Petitioners,

—against—

SUSAN TANNENBAUM and CHEMICAL FUND, INC.,

Respondents.

MOTION OF INVESTMENT COMPANY INSTITUTE FOR LEAVE TO FILE A BRIEF AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

Pursuant to Rule 42 of the Rules of the Supreme Court of the United States, the Investment Company Institute (I.C.I.) moves for leave to file a brief as *amicus curiae* in support of the petition for a writ of certiorari of F. Eberstadt & Co., Inc., F. Eberstadt & Co., Managers and Distributors, Inc., and Robert Zeller. This motion is necessary because the Respondent Susan Tannenbaum refused to consent to the filing of an *amicus curiae* brief by the I.C.I.

The I.C.I. is the national trade association of open-end investment companies ("mutual funds"), their advisers and underwriters. The mutual fund members of the I.C.I. have about 7.5 million shareholders and assets of about $43 billion, representing over 90% of the assets of the domestic mutual fund industry. The I.C.I. is generally recognized as the spokesman for the mutual fund industry to the public and to the government.

The March 4, 1977 decision of the Second Circuit Court of Appeals in this litigation held that a mutual fund was required to disclose in its proxy statements what the Court determined to have been a reasonable business judgment of its Board of Directors to forego the possibility of recapture of "excess" brokerage commissions. This type of disclosure has never been required by the Securities and Exchange Commission, is inconsistent with industry and administrative understanding and practice, is inconsistent with the reliance placed on the independent directors by the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 et seq., and will not provide relevant information to shareholders of a mutual fund.

The I.C.I. wishes to point out to the Court the adverse consequences which the Second Circuit's decision is likely to have upon the mutual fund industry and also upon other corporations which are subject to the disclosure requirements of the federal securities laws. The I.C.I. therefore respectfully prays that the Court grant this motion for leave to file its brief in support of the petition.

September 16, 1977

Respectfully submitted,

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Respondents.

BRIEF OF INVESTMENT COMPANY INSTITUTE, *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

This brief is submitted on behalf of the Investment Company Institute ("I.C.I.") as *amicus curiae* in support of the petition for a writ of certiorari filed by F. Eberstadt & Co., Inc., F. Eberstadt & Co., Managers and Distributors, Inc., and Robert G. Zeller (the "Petitioners"). The principle of disclosure advocated by the decision rendered against the Petitioners is important and generally applies to the mutual fund industry and also to all other corporations which are subject to the disclosure requirements of the federal securities laws. The ICI strongly believes that this issue merits the attention of the Court.

The I.C.I. is the national trade association of open-end investment companies ("mutual funds"), their advisers and underwriters. The mutual fund members of the I.C.I. have

about 7.5 million shareholders and assets of about $43 billion, representing over 90% of the assets of the domestic mutual fund industry. The I.C.I. is generally recognized as the spokesman for the mutual fund industry to the public and to the government.

The I.C.I. urges that this Court grant the petition for a writ of certiorari in respect of the determination by the Second Circuit Court of Appeals that the proxy statements of Chemical Fund, Inc. (the "Fund"), a Delaware corporation, for the years 1967-1971 violated the disclosure provisions of the federal securities laws by failing to disclose what the Court of Appeals determined to have been a reasonable business judgment of the independent board of directors to forego the possibility of return of the "excess" portion of portfolio brokerage commissions (referred to as "recapture"). This brief is addressed solely to this aspect of the Court of Appeals' decision.

SUMMARY

Under applicable law and for pertinent policy considerations, disclosure of the possibility of recapture and a decision of the independent directors to forego recapture is not, and should not be, required—particularly in the context of a decision characterized by the Court of Appeals as a reasonable business judgment (A-61).[1] This type of disclosure (i) has never been required by the Securities and Exchange Commission (the "SEC") and, indeed, was specifically considered and rejected by the SEC after being proposed for public comment as a possible disclosure guideline; (ii) generally is not reflected in proxy statements of mutual funds during the period in question and, thus, is

[1] References preceded by "A" are to the appendix to the Petition submitted by the Petitioners.

contrary to longstanding industry and administrative understanding and practice; (iii) is inconsistent with the reliance placed on the independent directors by the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 et seq. (the "1940 Act"), thereby implicitly casting doubt upon the good faith judgment of the independent directors and their discretion in the management of corporate business and affairs; and (iv) will not provide information that is relevant to shareholders of a mutual fund.

The Court of Appeals' decision that a long-standing industry disclosure practice was, in retrospect, incorrect could have a widespread disruptive impact upon the mutual fund industry and, ultimately, upon other industries as well.

ARGUMENT

I.

Under applicable law and industry practice disclosure of the possibility of recapture and the decision of the independent directors to forego recapture is not, and should not be, required.

A. The SEC has not required disclosure of the possibility of recapture and the decision not to recapture and such disclosure has not been common practice in the mutual fund industry.

In general, the materiality of a disclosure depends on the facts and circumstances of the particular event. However, the type of disclosure about recapture which the Court of Appeals has suggested may be characterized as "generic" in nature, since it was a disclosure which would be common to many mutual funds. The factual variables in this context would seem limited.

Unlike the case with industrial or other companies, mutual funds are under continuing surveillance by the SEC as a result of its constant review of filed materials (proxy statements, current prospectuses and annual reports), inspections and investigations of practices and procedures, and its substantive regulation over their activities. The SEC has also been active in the development of specific disclosures for mutual funds, and the mutual fund industry has grown to rely upon the SEC practice of establishing disclosure guidelines, including those relating to the form and content of generic disclosures.[3] Thus, mutual fund disclosures have been both standardized and increased in a standardized manner through the process of accretion, primarily in response to SEC requirements, whether by the so-called "letter of comment" technique or by the adoption by the SEC of specific disclosure guidelines.[3] This, in large part, accounts for the fact that a number of the types of disclosures made by a particular mutual fund are routinely strikingly similar to the disclosures made by most other similar mutual funds.

During the period in question there was, and currently is, nothing in the SEC forms for proxy or registration statements or otherwise which expressly required, or would suggest, the need for the disclosure as to recapture which the Court of Appeals would require. The SEC had considered and subsequently rejected a disclosure guideline concerning

[3] Mutual funds continuously register their shares under the Securities Act of 1933, 15 U.S.A. §§ 77a et seq. (the "1933 Act"), and are the subject of legislation specifically enacted for their regulation, *i.e.* the 1940 Act.

[3] *E.g.*, SEC Guidelines for Investment Company Registration Statements, Release No. 40-7220 (1972). The disclosures suggested in the guidelines, to the best of our knowledge, have been generally adopted in the mutual fund industry with only minor variations.

the possibility of recapture. In 1969 the SEC published for comment proposed guidelines for the preparation of Forms S-4 and S-5,[4] which would have required mutual funds to disclose the facts that recapture was possible and that the directors had elected not to recapture.[5] After comments received in response to these proposed guidelines were considered by the SEC, it formally decided in 1972 not to require this disclosure. Disclosure relating to recapture was required by the SEC only in instances where a mutual fund did recapture.[6] Thus, the SEC necessarily determined that disclosure about the possibility of recapture, and the directors' rejection of this option, was not material for inclusion in documents prepared in accordance with the federal se-

[4] Forms S-4 and S-5 are the applicable registration statement forms under the 1933 Act for the underlying shares of closed-end investment companies and mutual funds, respectively.

[5] Release No. 40-5634. Two alternative forms of suggested disclosure proposed by the SEC in this release were as follows:

Alternative #1:

"The Company's board of directors and its adviser could agree to make arrangements to return to the Company the benefit of a portion of the brokerage commissions charged on portfolio transactions. No such arrangements have been made."

Alternative #2:

"The Company's board of directors and its adviser could agree to make an arrangement with ..... & Company to return to the Company benefits equal to the brokerage commissions ..... & Company receives on portfolio transactions from which the investment adviser benefits. No such arrangement has been made."

[6] Release No. 40-7220. The form of suggested disclosure adopted by the SEC in this release was as follows:

"The Company and ..... & Company have made an arrangement whereby .....% of the net profit from brokerage commissions earned on Company transactions placed with ..... & Company is returned to the Company by ..... (describe the mechanism through which the Company benefits, *e.g.* in a reduction in the advisory fee)."

curities laws.[7] In respect of the generic disclosure under analysis, the determination of the SEC as to the adequacy of the disclosure should be entitled to significant weight and deference. The SEC is the agency charged with the administration, interpretation and enforcement of the federal securities laws; the Staff of the SEC continuously reviews proxy statements, prospectuses and reports of all mutual funds; the SEC has expertise in, and has specifically examined, industry-wide practices dealing with recapture and brokerage allocation; and the SEC is aware of the mutual fund industry practice of reliance upon a general disclosure pattern.

To the extent we have been able to determine, it was not the practice for those mutual funds which had decided not to recapture[8] to disclose that the directors had considered and rejected recapture.[9] Thus, such a disclosure obligation, retroactively imposed, could expose a substantial part of the industry to claims of liability uncertain in nature and amount for past conduct which, at the time, was in accordance with the applicable laws as then interpreted.

[7] The SEC decision on this issue should apply with equal force to the disclosure requirements for proxy statements. The Court has narrowed its holding to the proxy statements of the Fund for procedural reasons (A-61).

[8] A decision to forego recapture during this period was, in our belief, not unique in that a number of other mutual funds had made similar decisions. This was due in part to the fact that the law was unclear as to the circumstances under which recapture was permitted or required due to the inherent conflict of interest (real or apparent) in permitting recapture. The possibility of a conflict of interest was one of the factors considered by the independent directors of the Fund (A-57).

[9] This conclusion is based upon our knowledge of the mutual fund industry and a review of proxy statements of various mutual funds for the period in question.

B. The interests of the shareholders of mutual funds are protected by the independent directors.

More so than has been typically the case with industrial or other types of corporations, the 1940 Act has always contemplated an active role for the independent directors of mutual funds as "watchdogs" for the interests of the shareholders.[10] In fact, Congress, recognizing that shareholders of mutual funds are disinclined to remove or change a mutual fund's adviser,[11] strengthened the role of the independent directors by enacting the Investment Company Amendments Act of 1970 (the "1970 Amendments"),[12] the provisions of which were applicable for a part of the period in question. The Court of Appeals' decision on recapture disclosure is inconsistent with the Congressional intent as to the purpose and the role of mutual fund independent directors.

The Court of Appeals found that the independent directors of the Fund were fully and adequately informed by management of the possibility of recapture and that the directors did not breach their fiduciary duties to Fund shareholders by electing not to recapture (A-61). Therefore, in terms of the impact of the Court of Appeals' decision on the mutual fund industry, the environment is one in which the independent directors have exercised a reasonable business judgment, and, in such an environment, the interests of the shareholders are adequately protected without disclosure of the alternatives considered by the independent directors.

[10] See, *e.g.*, Sections 10(a) (composition of board of directors), 15(c) (approval of advisory and underwriting contracts) and 32(a) (selection of independent accountants), 15 U.S.C. §§ 80a-10(a), 80a-15(c) and 80a-32(a).

[11] See S.Rep. No. 91-184, 91st Cong., 2nd Sess. (1970), as reprinted in 3 U.S. Cong. & Adm. News, 91st Cong., 2d Sess. at 4901 (1970).

[12] Pub.L. No. 91-547, 84 Stat. 1413 (1970).

The interests of the shareholders of the Fund were also protected by the fact that more than 50% of the directors of the Fund were independent for the entire period in question.[13] Moreover, while the concept of a "disinterested" director was not introduced until the enactment of the 1970 Amendments, the independent directors were in fact "disinterested" for the entire period in question (A-21).

To require disclosure of the possibility of recapture and the independent directors' decision to forego recapture in these circumstances suggests that the action of the independent directors was suspect, and that shareholders should be fully informed respecting all possible alternatives of a good faith, disinterested judgment of the independent directors on what could only be the premise that the decision may not have been made properly. A decision to forego recapture is similar to many other alternatives relating to advisory agreements which the independent directors from time to time may consider. If the possibility of recapture should be disclosed, why not disclose other alternatives which can have a direct monetary impact on mutual funds —or, perhaps, the individual votes of directors on different issues? The securities laws traditionally have not required disclosure of this type of evaluation of alternatives, cer-

[13] Section 10(a) of the 1940 Act (15 U.S.C. § 80a-10(a)) had, before the effectiveness of the 1970 Amendments, required that 40% of a mutual fund's directors be "unaffiliated" (as defined in Section 2(a)(3), 15 U.S.C. § 80a-2(a)(3)) and currently requires that 40% of such directors be "disinterested" (as defined in Section 2(a)(19), 15 U.S.C. § 80a-2(a)(19)). Moreover, Section 10(b) of the 1940 Act (15 U.S.C. § 80a-10(b)) provides, under certain circumstances, that a majority of the directors of a mutual fund may not be (a) regular brokers of the mutual fund or affiliated persons of such brokers, (b) the principal underwriter of the mutual fund or interested (affiliated before the effectiveness of the 1970 Amendments) persons of such principal underwriter or (c) investment bankers or affiliated persons of investment bankers, and Section 10(c) of the 1940 Act (15 U.S.C. § 80a-10(c)) prohibits a majority of the directors of a mutual fund from consisting of officers, directors and employers of any one bank.

tainly not in the context of deliberations by independent parties, such as the independent directors in question. Moreover, in requiring disclosure of the decision making process of directors, the Court of Appeals' decision may inhibit the free flow of ideas among directors, thereby undercutting their effectiveness in managing the business and affairs of corporations as required by federal and state law.[14]

C. The omission of a disclosure in proxy materials as to the possibility of recapture and the decision of the independent directors to forego recapture is not material.

The proxy provisions[15] of the federal securities laws have been adopted as a means to furnish shareholders with information as to which there is a substantial likelihood that a reasonable shareholder would consider important in deciding how to vote. See *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L. Ed.2d 757 (1976). Matters as to which shareholders' votes were solicited in the instant case were the election of directors and the approval of the investment advisory agreement (A-70), and, to be material under the standard established in *TSC Industries*, it is necessary to determine that the information in question would be important in a determination of the qualifications of the persons nominated for election as

[14] If the state corporation laws are viewed for guidance, there is typically a separation between the type of decisions that are made by the directors and those which require shareholder approval. A decision concerning an issue such as the possibility of recapture is usually left to the discretion of the directors, who are charged with the fiduciary duty of managing the business and affairs of the corporation.

[15] Section 20(a) of the 1940 Act, 15 U.S.C. § 80a-20(a), and Section 14(a) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78n(a), and the rules promulgated by the SEC thereunder.

directors[16] or would be important to an evaluation of whether to approve an investment advisory agreement submitted to the shareholders.

Their good faith business judgment whether or not to attempt to recapture does not, we respectfully submit, concern the qualifications of the directors. Indeed, the Court of Appeals found that the actions and decisions of the independent directors were reasonable business judgments properly considered and determined (A-61). This holding is inconsistent with any suggestion that the qualifications of the directors were in question. Moreover, the availability of information important to the qualifications of directors and required by Rule 20a of the 1940 Act, 17 Code Fed. Reg. § 270.20a, is not at issue in the instant case.

Matters of importance to shareholders in voting upon investment advisory agreements (disclosures of which are not at issue here) include the financial position of the adviser and information concerning the executive officers of the adviser. Proxy statements traditionally discuss the various types of compensation received by an adviser from the mutual fund, but do not disclose alternatives possibly available to mutual funds, which are not availed of because of the good faith business judgment of the directors. The shareholders of the Fund were not required to vote, and, to the best of our knowledge, shareholders of mutual funds typically do not vote, on the discreet question of whether to recapture.[17]

[16] Thus, the proxy rules promulgated by the SEC under the 1940 Act require information about the principal occupation of all directors and their relationships with the mutual fund. See Rules 20a-2(a)(5)-(9), (11) and 20a-3(b), 17 Code Fed. Reg. §§ 270.20a-2(a)(5)-(9), (11) and § 270.20a-3(b).

[17] Provisions for commission sharing arrangements may be included among the many provisions in a form of advisory agreement to be voted upon by the shareholders.

We submit that the possibility of recapture is no more important to a shareholder voting on an investment advisory agreement than other alternatives which may have been considered and rejected by the directors, such as the selection of one of a range of possible advisory fees,[18] the allocation of expenses between the mutual fund and its adviser, whether the advisory fee should be asset based or performance based, the amount of the sales load on sales of the mutual fund shares, the manner by which the shares of the mutual fund are distributed or discussions relating to specific investment techniques utilized by the adviser—none of which matters are or should be normally disclosed in the context of a vote on an investment advisory agreement.

II.

The Court of Appeals' decision will have a disruptive impact on the mutual fund industry.

The mutual fund industry has been literally inundated by litigation over the last 15 to 20 years. The first major wave of litigation involved the "reasonableness" of the advisory fee.[19] This was followed by litigation concerning

[18] Advisory fees, which are subject to negotiation between the adviser and the mutual fund, are subject to no minimum or fixed rate structure. Thus, the range of possible fees is limitless and the alternatives available to the directors in negotiating a fee are far ranging. Not only is the amount of the fee subject to negotiation, but the composition of the fee is also flexible, *e.g.*, which expenses of operations should be allocated to the mutual fund and which should be allocated to the adviser (subject to certain state law restrictions).

[19] See, *e.g.*, *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961) and *Saxe* v. *Brady*, 184 A.2d 602 (Del. Ct. of Chancery 1962).

the sale of control of mutual funds[20] and then by a further flood of litigation involving mutual fund brokerage practices.[21] In general, the litigation has subsided for a variety of reasons, including the fact that Congress has essentially dealt with each of the areas that was the subject of litigations. The question of the reasonableness of management fees was explicitly considered by the 1970 Amendments in Section 36(b) of the 1940 Act, 15 U.S.C. § 80a-36(b); the issue of the sale of control of mutual funds was focused upon in the Securities Acts Amendments of 1975[22] (the "1975 Amendments") by Section 15(f) of the 1940 Act, 15 U.S.C. § 80a-15(f); and the question of brokerage practices was addressed in the 1975 Amendments by Sections 6(e) and 11(a) of the 1934 Act, 15 U.S.C. §§ 78f(e) and 78k(a).

Due to the establishment of competitive rates of brokerage commissions,[23] and the adoption of Section 11(a) of the 1934 Act, 15 U.S.C. § 78k(a), by the 1975 Amendments (basically prohibiting the combining of brokerage with discretionary investment management after May 1, 1978), mutual funds are, as a practical matter, not at present faced with the decision of whether to avail themselves of the form of recapture at issue in the instant case.[24] However,

[20] See, *e.g.*, *SEC* v. *Insurance Securities, Inc.*, 254 F.2d 642 (9th Cir. 1958), cert. denied, 358 U.S. 823, 79 S.Ct. 38, 3 L.Ed.2d 64 (1958) and *Rosenfeld* v. *Black*, 445 F.2d 1337 (2d Cir. 1971).

[21] See, *e.g.*, *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir. 1971), cert. denied sub. nom. *Johnson* v. *Moses*, 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed.2d 547 (1971) and *Fogel* v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975), cert. denied, 429 U.S. 824, 97 S.Ct. 77, 50 L.Ed.2d 86 (1976).

[22] Pub. L. No. 94-29, 89 Stat. 97 (1975).

[23] See Rule 19b-3 promulgated by the SEC under the 1934 Act, 17 Code Fed. Reg. § 240.19b-3, which became effective as of May 1, 1975, and Section 6(e) of the 1934 Act, 15 U.S.C. § 78f(e).

[24] The SEC is currently considering proposed rules under Section 11(a) of the 1934 Act, 15 U.S.C. § 78k(a), which, if adopted, might permit mutual funds the opportunity to obtain a form of possible recapture. See SEC Release No. 34-13388 (1977).

as indicated, the Fund was not unique in not disclosing the directors' consideration and rejection of this form of possible recapture, and the Court of Appeals' decision could have a wide ranging disruptive impact upon the mutual fund industry, casting doubt about actions taken under proxy statements in prior years. A new round of litigation could be triggered, involving many of the same substantive matters that have already been addressed by Congress, but contending that inadequate disclosure has been made respecting these issues in the past.

The Court of Appeals' decision is also likely to precipitate additional litigation alleging non-disclosure of any number of other alternatives considered and rejected by directors where such disclosures had not been made by members of the mutual fund or other industries. Shareholders of mutual funds and other corporations will not be benefited by the proposed disclosures, and unknown and uncertain liabilities on a broad basis could be created by the Court of Appeals' decision.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari filed by the Petitioners to review the judgment of the United States Court of Appeals for the Second Circuit should be granted.

September 16, 1977

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